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C O N F I D E N T I A L SECTION 01 OF 03 KUALA LUMPUR 001112

SIPDIS

STATE PASS USTR -- WEISEL AND BELL
STATE PASS FEDERAL RESERVE AND EXIMBANK
STATE PASS FEDERAL RESERVE SAN FRANCISCO TCURRAN
SINGAPORE PASS TO SBAKER
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SUBJECT: MALAYSIAN OIL PRODUCTION MOVING TO DEEPER WATERS

Classified By: Deputy Chief of Mission Robert G. Rapson for reasons 1.4
(b) and (d)

¶1. (SBU) Summary: As crude oil production from Malaysia's shallow waters tapers off, oil companies are exploring and developing oil fields in deeper waters. Kikeh, Malaysia's first deepwater field, is producing 100,000 barrels per day (bbl/day) and is on track to reach its full production target of 120,000 bbl/day by year end. Gumusut, Malaysia's second deepwater oil reserve, is expected to come onstream in 2012 or 2013, further boosting Malaysia's slumping production levels. Malaysia also is expanding production of its significant natural gas reserves. Professionals from both Murphy Oil Corp and Royal Dutch Shell expressed frustration with Malaysia's racial preference policies for ethnic Malays (bumiputera), giving examples of how the policies impact their businesses. Murphy executives told Ambassador Keith when he visited the facility in mid-November that they hoped Malaysia and the U.S. would adopt a Free Trade Agreement that could put many of their frustrations to rest. Although the Kikeh reserve is believed to stretch into disputed territorial waters with Brunei, Murphy's production manager no longer anticipated a need to inject pressure from the opposite end of the field to maintain production. While the dispute is unlikely to affect production at Kikeh, Murphy's production sharing contract (PSC) with Petronas to develop the disputed Block L expires next year; Murphy execs hope both sides reach an agreement that allows the PSC to be extended.

¶2. (SBU) Comment: The shift of Malaysian production from shallow waters to less accessible deep reserves off the shelf edge underlines the state of Malaysian reserves: production is going strong for now, but it's time to start preparing for a future without oil money, which makes up 40 percent of federal revenue. Economic reforms, especially reforms to the nation's racial preferences, would go a long way toward improving the business climate and boosting the economy. End Summary and Comment.

DEEPWATER OIL PRODUCTION

¶3. (U) Kikeh is Malaysia's first deepwater oil and gas field, operated by Murphy Oil Corp. on an 80:20 joint venture basis

with Petronas, Malaysia's national oil company. It is located in Block K, 65 nautical miles northwest of the East Malaysian state of Sabah (on Borneo). Discovered in 2002 in an undersea depth of more than 4000 feet, Kikeh came onstream in August 2007, initially producing 40,000 bbl/day with a target of 120,000 bbl/day at full production. Murphy was operating seven wells from the spar, a hollow underwater cylindrical structure with a three-storey topside. Murphy Senior Production Manager Bill Hughes told Ambassador Keith and visiting Econoff on November 18 that total production had reached 100,000 barrels per day and that three additional wells would be added by the end of the year with additional wells being drilled from a separate Mobile Drilling Unit. Drilling is quicker and more efficient from the spar, he explained, but can be done only within a 25-meter radius. Kikeh's recoverable reserves are estimated at over 400 million barrels. Murphy also is drilling exploratory wells in Block P, northeast of the Kikeh field.

ON THE HORIZON

¶4. (C) Murphy also has a 15 percent financial stake in Gumusut, Malaysia's next-in-line deepwater field. Royal Dutch Shell is the operator. Murphy execs claimed that Shell had used a spar design they had used previously, but had enlarged the topside without sufficiently enlarging the base. The topside, which weighed 3000 pounds, was too heavy to be supported by the base. The original end-2011 target date of first production would not be met, they said; rather, they estimated that Gumusut was more likely to begin production in ¶2013.

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¶5. (C) The following week a contact from Shell denied that there was a problem with an overweight topside, in response to Econoff's enquiry. When asked when he thought Gumusut would come onstream, he repeated the target date of end-2011 but expressed frustration at the GOM's tightening bumiputra policies, saying that Murphy had been allowed to bring in foreign engineers since it was the country's first deepwater operation. Now, the GOM was insisting on using Malay engineers. This contact told econoff that training and monitoring a team of Malay engineers took more time than simply doing the work.

DISPUTED TERRITORIAL WATERS

¶6. (C) Block K, containing both Kikeh and Gumusut, is undisputedly in Malaysian waters, according to Murphy General Manager Ted Botner, but the oil reserves are believed to extend into waters disputed by Brunei in neighboring Block L. Earlier in the development cycle, Murphy executives had expressed concerns about whether they would need to inject pressure from the opposite end of the Kikeh reserve (in Block L), but as production was going well this was no longer an immediate concern. However, Malaysia had granted exploration rights to Murphy in Block L under a PSC which expires in ¶2010. Botner told the Ambassador during his visit to the Kikeh production facility that he thought ultimately an agreement between the two countries would designate the disputed territory a joint development area in which all partners would have a stake: Murphy, Shell, Total, Petronas, and the Bruneian National Oil Company.

NATURAL GAS PRODUCTION

¶7. (C) Kikeh produced 120 million cubic feet of gas per day, Hughes explained, and Gumusut was expected to produce significant amounts of natural gas as well. A plant in nearby Labuan would convert the natural gas into methanol, but being the only buyer it would not offer international market prices, according to Hughes. An undersea pipeline was in place to transport the gas, but the plant was being expanded to increase its capacity to receive and process the additional gas. Hughes was mildly supportive of the proposed

Kimanis-Bintulu gas pipeline, which could enable Murphy to sell the Kikeh gas in Bintulu, Sarawak where more competition helped ensure international market prices. However, Hughes was skeptical about whether Murphy actually would see profits from the gas, even if the Kimanis-Bintulu pipeline were in place. Petronas was the more likely beneficiary, he said. Murphy maintains other oil and gas operations in Bintulu and is developing three new gas fields off the Sarawak coast (Merapu, Golak, and Serampang).

IMPACT OF A FREE TRADE AGREEMENT

18. (C) Botner told the Ambassador that an FTA had the potential to significantly improve their ability to do business effectively in Malaysia. He cited three areas where Murphy would gain: procurement, cost structures, and taxes. Most of the discussion revolved around Malaysia's racial preference requirements for ethnic Malays, or bumiputera, which permeate Murphy's PSC. Murphy must use bumiputera-owned vendors where such are available. In some cases, a single vendor was selected by Petronas without consulting Murphy; in other cases, Murphy was given a list of bumiputera-owned companies deemed by Petronas to be qualified from which to choose. When parts or supplies ran short, Murphy could apply for a waiver to allow them to procure from a non-bumiputera vendor, but approval was given only in serious cases, such as when production otherwise would come to a halt. For less essential items, they generally had to wait until the bumiputera vendor could provide it.

19. (C) As an example of the frustrations resulting from these policies, Hughes cited the case of a pipe-laying vessel Murphy contracted to connect the three new offshore Sarawak gas fields with facilities in Bintulu. A bumiputera-owned

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pipe-laying vessel had bid on the contract but was disqualified because its maximum capacity was to lay 8-inch diameter pipes. To transport the gas from the three new fields at expected rates of production, 12-inch diameter pipes were required. The bumiputera-owned vessel was disqualified, the Ministry of Transportation issued a permit to a foreign pipe-laying vessel, and the work began.

10. (SBU) However, the bumiputera owner of the disqualified vessel complained to the Ministry of Transportation, which then rescinded the foreign vessel's permit retroactively, rendering illegal even the work it already had completed while it had held the permit. Work stopped and the foreign vessel departed from Malaysian waters until the company finally resolved the problem with the help of the (Malaysian Chinese) Minister of Transportation himself. Murphy executives did not know the details of how the problem had been resolved; they speculated that the company that owned the foreign vessel had enlisted the help of Petronas to mediate the dispute with the Ministry. Finally, their permit was restored and work continued.

KEITH